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RURAL DEPOSIT MOBILIZATION:

AN ALTERNATIVE APPROACH FOR DEVELOPING

RURAL FINANCIAL MARKETS

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RURAL DEPOSIT MOBILIZATION: AN ALTERNATIVE APPROACH FOR DEVELOPING RURAL FINANCIAL MARKETS[1]

I. INTRODUCTION

1. Major efforts have been made the past two decades to develop and improve agricultural credit systems and expand the flow of loans to agriculture in low income countries (LICs). During the past several years, aid agencies have provided over $U.S.5 billion dollars for rural financial market (RFM) projects, and the volume of new agricultural loans in LICs was in excess of $U.S.30 billion per year in the early 1980s [Adams and Graham]. Foreign assistance has played a major role in the design of RFM projects, providing funds for on-lending, linking external funds to the provision of internal funds, and through technical assistance and training. The U.S. Agency for International Development (AID) has financed a number of these RFM projects in several countries.

2. Two sets of problems have emerged which suggest that the traditional approach to RFM projects must be fundamentally restructured. First, many LICs now face difficulty in obtaining adequate foreign funds for economic development. It is increasingly clear that internally mobilized funds must substitute for external finance [Abbott; FAO (1984a,b); Fry, (1984); S. H. Kim]. External funds are not likely to be as abundant in the future as in the past; aid agencies face constraints on funds and commercial lenders are wary of increased lending to some LICs. Furthermore, the terms and conditions of both foreign assistance and commercial loans have hardened, and many countries must increase national savings to repay previous loans. The Latin American region faces the most serious savings challenge because net capital inflow actually turned negative in 1982 and 1983 [Caceres].

3. Second, even if external finance would be abundant, the traditional approach to RFM projects is questioned because of the serious shortcomings now evident in many LICs. Most projects have not lived up to expectations. The problems are so pervasive that the underlying assumptions on which the projects are designed and implemented must be questioned. The substantial body of research now available points to a new approach in the development of rural financial markets which is based on a greater reliance on savings mobilization as the source of funds for rural lending.

4. The objective of this paper is to summarize the arguments made for increasing rural deposit mobilization in LICs. The main points can be summarized as follows: A major reason for the failure of RFM projects is that they are designed primarily to channel government and/or donor funds to targeted borrowers. Little attempt is made to

generate more reliable supplies of funds through deposit mobilization. Rural savers are denied secure and remunerative savings opportunities. Financial institutions must be strengthened to more effectively mobilize rural savings. To accomplish this task, policymakers must change priorities from pushing cheap credit to building viable rural financial institutions. A reorientation in priorities will facilitate making important policy changes such as the structure of administered interest rates. More emphasis on deposit mobilization should improve rural savings and the performance of financial institutions. Several technical issues must be faced when institutions broaden the range of financial services they offer. Strong central banks can facilitate the resolution of the challenges that will arise. The role of foreign assistance should change from providing large amounts of funds for on-lending to assisting countries make the adjustments associated with serious financial reform.

5. This paper is divided into six sections as follows: Part II reviews key concepts of financial intermediation and rural finance. Part III summarizes assumptions and problems of RFM projects. Part IV discusses the potential for and determinants of rural deposit mobilization. A discussion of the link between rural savings and the viability of financial institutions is presented in Part V. Part VI analizes the arguments made concerning controls over intersectoral resource flows. Part VII identifies some of the technical issues that governments and international agencies will need to confront in implementing financial reform. Part VIII presents some concluding comments.

II. FINANCIAL INTERMEDIATION AND RURAL FINANCE

6. RFM projects are frequently designed considering only the farm level demand for credit, but rural households benefit from a variety of financial services. Ignoring the broader role of finance in economic development can lead to projects which actually retard the development of the financial sector. It is useful, therefore, to summarize a few key financial concepts before discussing the specifics of RFM projects.

7. Financial intermediation is the process by which financial institutions mobilize savings from surplus units (households and firms) and allocate them to deficit (borrowing) units. Surplus units save, and hence, reduce current consumption in order to increase future consumption. Deficit units obtain credit to do just the opposite. Interest payments are incentives for surplus units to postpone consumption. Financial intermediation involves formal and informal institutions using various financial instruments. Most LICs have relatively simple financial markets that increase in complexity as income levels rise. Financial intermediation in rural areas generally involves banks (commercial and specialized), postal savings offices, cooperatives, credit unions and a variety of informal

intermediaries that utilize a small number of deposit and savings instruments and legal documents for farm household loans. Government involvement in rural finance has stressed the development of credit-oriented, rather than savings, institutions.

8. Many economists support Keynesian views that interest rates should be kept low to accelerate investment and accumulation of capital. A markedly different theoretical argument began to emerge with the attacks on financial repression in LICs by Shaw, McKinnon and others in the early 1970s. Whereas the Keynesian view emphasizes the impact of interest rates on investment, the Shaw-McKinnon argument focuses on the impact of interest rates and other controls on the supply of finance. They argue that the accumulation of real capital and the accumulation of financial assets in developing economies are complementary rather than competitive. A comprehensive review of the original Shaw-McKinnon argument, subsequent refinements and related empirical studies can be found in Fry (1982).

9. Financial repression refers to deliberate distortions of prices, including interest rates and foreign exchange rates, that reduce the rate of growth and size of the financial sector relative to the rest of the economy. A repressed financial system is one with government-imposed ceilings on loan and deposit interest rates, foreign exchange controls, high reserve requirements, and lending quotas and targets. An expansion in lending to priority sectors and activities is encouraged through targeting of loans, preferential rediscount rates, regulations on approved types and sizes of loans, specifications on margin and collateral requirements, and the creation of specialized institutions such as development banks. Several countries have nationalized their banking systems to try to better achieve social objectives. The result of these several types of government intervention is a financial system which is fragmented, segmented and restricted. Savers are generally penalized by low rates paid on deposits, while privileged groups of borrowers are favored with preferential credit terms.

10. Debate continues over the relevance of the Shaw-McKinnon argument and its implications for specific countries (for examples, see Gupta; Roe). The rapid economic growth of Taiwan and South Korea following the introduction of financial reforms is often cited as support for the argument. Recent studies of several Asian LICs are also supportive by showing that raising real deposit rates increased financial savings, thereby improving credit availability [Abbott, Fry and Krishnaswarmy; Fry (1984)]. Furthermore, an increase in real deposit rates increased the average efficiency of investment. These two effects contributed to raising the economic growth rate in these countries.

11. In addition to a positive impact on efficiency and growth, improved financial intermediation can also make an important contribution to equity through both savings and lending activities. Consider the impact on savings of a reduction in financial repression

through raising both minimum lending and deposit rates. As discussed in Part IV, an increase in real deposit rates should stimulate financial savings by increasing incentives for postponing consumption.[2] Since the number of depositors in any financial institution generally exceeds the number of borrowers, an increase in deposit mobilization should benefit many saving households. Wealthier households have a variety of investment choices including both physical and financial assets. Poorer, less sophisticated households, however, frequently have access only to financial investments. An increase in deposit rates can, therefore, make a positive impact on income distribution through ownership of savings instruments.

12. An improvement in equity can also occur through lending. The lower that loan interest rates are set relative to equilibrium rates, the greater will be the excess demand for loans and the need for lenders to impose nonprice loan rationing through noninterest terms of the loan contract and the size of loan granted [Bhatt and Roe; Gonzalez-Vega (1984a)]. When interest rates are suppressed, loans become concentrated among wealthy borrowers who can meet high collateral requirements and who can use political influence to obtain loans. Poor borrowers without influence and collateral but with high rate-of-return investment projects are crowded out and are denied loans. Raising loan rates restores interest as the loan rationing mechanism. Poor borrowers have a better chance of getting loans and low rate-of-return projects are eliminated. This is the mechanism through which an increase in investment efficiency occurs, and it can also contribute to a more equitable distribution of loans.

13. Agricultural specialists are frequently preoccupied with the credit "needs" of farm households. There is seldom recognition that financial services can provide several benefits to farm households [Adams (1984a)]. First, monetization can make it less expensive for the farm household to meet obligations by transferring resources through a check or bank draft rather than through the transfer of physical assets. Second, resource allocation may be more efficient because a financial institution can facilitate resource transfers between surplus and deficit units separated too far by time and distance to engage effectively in direct exchange. Third, financial institutions can provide a credit reserve useful to farmers facing risk. By having access to a ready supply of loans, farmers can take the risk of committing more of their own funds to investment. Fourth, an intermediary can help a household accumulate savings to combine, perhaps, with a future loan to finance a large investment. Fifth, financial institutions help with intergenerational transfers of claims on resources.

14. The heterogeneity of farm households is widely acknowledged in terms of the types and sizes of farms for which RFM projects are appropriate [Donald, p.15], the ability of institutions to meet rural credit demands [FAO (1981a),p.4], and the credit needs of different groups of farmers [FAO (1981b, p.14]. Differences among farm

households in wealth, income, access to land and size of landholding are important, but the heterogeneity in household cash flow is even more important for financial intermediation [Meyer and Alicbusan]. This heterogeneity arises because of differences in cropping patterns, enterprise combinations, procurement and marketing strategies, consumption patterns, and family life cycles. RFM projects often assume that, because of crop seasonality, most households will experience cash flow surpluses and deficits at approximately the same time of the year. However, detailed cash flow studies in LICs show that patterns of income and expenditures in farm households are more complicated. The fact that some households experience surpluses at the time that others face deficits provides opportunities for rural financial intermediation. Since some surpluses are sizeable and exist for an extended period of time, many farm households could effectively use loans and saving services to help synchronize income and expenditures. Furthermore, some households are continuous net savers and find long-term financial investments attractive.

III. TRADITIONAL RURAL FINANCIAL MARKET PROJECTS

15. Until recently, most RFM projects have been designed as credit projects to push farm loans, frequently at subsidized rates, and the savings mobilization side of financial intermediation has been forgotten or deemphasized [Vogel (1984a)]. The central objective has been to improve production and farm incomes. This strategy has been complementary with the development of projects which justify a cheap credit component to speed farmer adoption. The result is that both RFM and integrated projects, as traditionally designed, contribute to fragmentation of financial markets. A few borrowers monopolize the subsidized credit, the lending institutions are drained of their financial viability, and nonpriority borrowers are forced to pay rates that are higher than would prevail without financial repression.

16. The design of traditional projects has been based on faulty assumptions; the consequences for efficient rural financial intermediation are well-documented and will only be summarized here [Adams and Graham; Adams, Graham and Von Pischke; APO; Donald; Howell; Inter-American Development Bank; Von Pischke, Adams and Donald]. Common assumptions about farmer-borrowers are that they are highly risk averse, will resist adoption of innovations unless bribed by low interest rate loans, will misappropriate loans unless they are given in kind rather than cash and will not repay loans unless pledged with collateral or subject to the pressure of group lending. Surprisingly, these assumptions imply irrationality in the use of finance even though the concept of peasant rationality became well-established with the seminal work of Theodore W. Schultz in 1964. These assumptions lead to targeting of loans for specific borrowers; detailed specification of sanctioned loan uses and amounts; elaborate procedures for in-kind lending, loan disbursement

and supervision; and required collateral substitutes like group lending or compulsory marketing schemes. Maximum lending rates are set below market equilibrium with subsidies provided by governments or international agencies through favorable rediscount arrangements or direct credit lines. Loan interest rates for small farmers and other disadvantaged groups are frequently set at rates lower than for other borrowers. It is expected that low-income households will be pulled out of their poverty by properly adopting the recommended investment-credit-production package. It is also expected that subsidized credit will offset production disincentives caused by high input prices or low product prices.

17. Assumptions about the behavior of rural savers and formal lenders also influence the design of traditional RFM projects. Rural households are assumed to be either too poor to save or indifferent to rewards for saving. Lenders, therefore, cannot mobilize rural deposits in a cost-effective manner and must receive subsidized funds for on-lending. Furthermore, commercial banks are risk averse and will not make socially desirable amounts of loans to farmers unless enticed or compelled to do so. Commercial banks may be nationalized and/or complemented with specialized development banks to increase farm lending. Since informal lenders are assumed to charge usurious rates and gobble up assets pledged to them, formal sources must be expanded to force down interest rates or, better yet, drive informal lenders out of business.

18. Some positive outcomes can be associated with traditional credit projects: the aggregate amount of agricultural loans has increased in some countries, commercial banks have increased their technical capacity to make farm loans, some farmers have received large amounts of loans and the expansion in use of mechanization, new seed varieties, fertilizers, chemicals and new cropping systems is attributed to increased lending in some areas. However, serious problems in many countries have led to a reassessment of traditional views about agricultural credit. Changes in the farm level use and distribution of loans have fallen far short of expectations. Some estimates suggest that still only about 15 percent of Asian and Latin American farmers and no more than 5 percent of African farmers have had access to institutional credit. The ratio of agricultural loans to agricultural GNP and the ratio of agricultural loans to total loans have often risen very slowly, if at all. All too frequently, donor funds have simply substituted for domestic sources with little net impact on total volume of agricultural loans.

19. Agricultural loans are often heavily concentrated in the hands of a few wealthy farm households [Gonzalez-Vega (1984b); Vogel (1984b)]. Even in the exceptional case of Brazil, where the agricultural credit to agricultural production ratio grew from 0.2 in the mid 1960s to almost 1.0 by the mid 1970s, it was difficult to increase the volume of loans going to small farmers and poorer regions [Araujo and Meyer; Meyer et al]. Interest subsidies on loans equal billions of U.S. dollars and represent 20 to 30 percent of

agricultural production in some cases [Sayad; Vogel (1984b)]. The concentration of loans and subsidies, the impact on incomes due to leverage obtained from loans, and the concentration of loan delinquencies have seriously aggravated the distribution of rural incomes and wealth [Adams and Meyer].

20. Farmers continue to rely on informal loans. The reasons include the high borrowing (interest and noninterest) costs of formal loans caused by credit rationing [Ahmed; Ladman], the high value that farmers place on maintaining good relations with dependable informal sources relative to undependable formal sources, the convenience of informal sources and their responsiveness to customer needs [Holst], and the linkage between land and credit in traditional land tenure arrangements [Braverman and Srinivasan].

21. Although many attempts have been made, it is impossible to satisfactorily quantify the impact of increased agricultural loans on farm household production, income and choice of technology [David and Meyer]. Many factors other than credit affect differences in economic performance between borrowers and nonborrowers. Funds are fungible so it is difficult, if not impossible, to effectively target loans. The additional agricultural production and investment associated with increased loans is usually much less than expected because of diversion and substitution of funds. Due to the methodological problems of farm level credit impact studies, it is more useful to evaluate the impact of RFM projects on supply of funds and institutional viability.

22. Many financial institutions are experiencing problems even more serious than those at the farm level. Few institutions are readily expanding their agricultural loan portfolios, most loans are still short-term and rigid collateral requirements are in effect. Actual loan allocations often differ so greatly from targets that the value of credit planning and programming is seriously questioned [Vogel and Larson]. Many financial institutions are essentially bankrupt and exist only through government or external subsidies. Accrued interest on delinquent loans (frequently with little probability of being repaid) represents a large portion of reported income. Other methods to "cook the books" are used to disguise the viability problem and prevent a cut-off of foreign funds. Institutional recycling is common. An institution is created with great fanfare and a large infusion of funds. Because of high loan transactions costs, inflation and loan defaults, the real value of the initial capital eventually disappears. The institution is subsequently renamed or merged with another institution, another injection of capital is provided and the cycle starts again.

23. The minimum interest spread between cost of funds and lending rates necessary to ensure financial viability is high. Intermediation costs are naturally high in LICs because of low volume, inefficiency, and poorly developed systems of transportation, communications and information in rural areas, but traditional RFM

projects also raise costs through loan targeting. Dozens of individual agricultural credit lines and projects have been developed in many countries. Although the cost of funds lent may be low, total lending costs for institutions may be two or three times as high for loan-targeted programs compared to other credit lines because of the high administrative overheads required [Cuevas and Graham (1984a)]. The interest spreads authorized may be far below costs, thereby discouraging lender participation. Lenders reduce lending costs and ration loans by transferring part of their transactions costs to borrowers. Borrowing costs tend to be highest for small loans, poor borrowers, borrowers of targeted loan programs, and first-time borrowers of an institution. High borrowing costs for formal loans encourages informal borrowing [Cuevas and Graham (1984b)]. Some institutions lack the motivation and means to reduce transactions costs [Bhatt], but spend much effort to avoid regulations that work against market forces [Kane].

24. Low loan repayment rates also drain institutional viability. [Boakye-Dankwa; World Bank]. The situation is worse than the reported data imply because of the widespread refinancing of old unpaid loans. Borrower inability and unwillingness to repay have been identified as major loan recovery problems, but poor collection procedures may be more important in some institutions [Maharjan, Loohawenchit, and Meyer]. The disastrous consequences of low loan recovery have been analyzed [Von Pischke (1981)]. Funds are unavailable for recycling, collection costs rise, staff may become demoralized, respect for contracts declines, and institutions become vulnerable to political interference over who receives and who repays loans. Defaulting borrowers may be denied future access to financial services so their loans become one-shot income transfers, rather than the first step in developing a long-term relationship with a financial institution.

25. Finally, inflation destroys institutions because inflation rates are often high and variable while administered interest rates on loans and deposits are low and inflexible. Real deposit rates are often negative and, all too frequently, so are lending rates. Because operating costs, delinquency rates and inflation are high, institutional viability usually requires lending rates in excess of twenty percent, but many governments find that charging such rates is inconsistent with their cheap credit objectives.

IV. RURAL DEPOSIT MOBILIZATION

26. Critics of traditional RFM projects argue that a fundamental reorientation must occur with greater emphasis placed on rural deposit mobilization. By pushing credit to farmers at cheap rates and supplying funds for on-lending, governments and donors create conditions that destroy institutional viability, discourage deposit mobilization and deny rural households good opportunities for financial savings. The ability of RFMs to expand is dependent on

government funds, and this is an important reason why governments have eagerly embraced donor sponsored RFM projects. Deposit mobilization must expand if LICs are to break their dependence on foreign savings and if RFMs are to perform more effectively.

27. The paradox in many LICs is that although it is common wisdom that agriculture must provide resources for other sectors during the early stages of development, few countries aggressively attempt to mobilize rural deposits. Five points must be emphasized regarding rural savings potential. First, all households save no matter how poor, even if in small amounts for short periods of time. Abstention from consumption is normal and necessary for survival even if the interval before consumption is fairly short [Von Pischke (1983)]. Second, farmers save automatically. When production and consumption cycles are not synchronized, farmers regularly store some produce for consumption until the next harvest. Alternatively, they may choose to sell their harvest, pay past debts or expand consumption, and borrow before the next harvest [Bouman]. Third, since rural households are heterogeneous, the possibility exists for institutions to mobilize funds from households with surpluses to channel to those with deficits. Fourth, while some rural areas are growing at slow rates and barely keep up with population growth, other areas are experiencing rapid changes in enterprises and technology. Rapid income growth due to technological change can increase rural consumption, savings and investment [Mellor]. Indian data show that savings/investment ratios in better-irrigated, more rapidly innovating regions were up to 3 to 15 times the all-Indian average [Krishna and Raychaudhuri]. Fifth, foreign remittances offer new savings potential for several countries. Some countries have been fairly successful at mobilizing these remittances, but much remains to be done. A recent study in Pakistan showed that much of the $U.S.2 billion received in annual remittances went to rural areas, but only 1.5 percent were channelled into financial assets [Jetha, Akhtar and Rao].

28. Analysts have identified many determinants of household savings behavior [Dell'Amore; Ligeti; Mottura; Von Pischke (1983)]. There is often conceptual confusion over the distinction between savings, defined as abstinence from consumption, and financial assets, which represent one form of holding a stock of savings. The decision to hold financial assets may or may not affect aggregate savings. Recent research makes a careful distinction between aggregate savings and financial assets, and tests the substitutability among forms of savings [Fry (1984); Gupta]. Relatively more research has been done on the factors that affect aggregate savings than on the determinants of financial assets.

29. Political and economic stability are important for any economic activity. The threat of revolution, unrest, expropriation, and disruptions in production raise the risk premium on capital and encourage private capital flight and investment in unproductive assets such as gold [Dell'Amore; Wachtel]. Inflation and economic

stability in the relation between domestic and foreign currencies affect the choice of currency held and place a high risk premium on the required return to savings. The degree of monetization is an important factor affecting rural deposit mobilization [Chandavarkar (1977)]. Both subsistence and barter are declining in many rural economies, but poor markets, high inflation, and political and economic uncertainty encourage rural households to hold excess crops, livestock and other physical assets.

30. One generally accepted proposition is that savings are positively related to income, but there is wide disagreement about the exact relationship between savings (marginal and average) and current income, past income, income growth and characteristics of households [Mikesell and Zinser]. The relationships are complex enough to preclude the specification of a savings function related to per capita output as the single independent variable. Higher income households clearly have a greater capacity to save and should have a higher average propensity to save. Furthermore, higher income households may hold higher transactions balances in financial institutions and prefer asset portfolios with combinations of financial and physical assets. As their financial assets increase in absolute amount, the per unit transactions costs of making and withdrawing deposits should fall, thereby increasing the real rate of return. On the other hand, higher income households may have greater access to a wider range of investment alternatives and be more sensitive to low returns earned from financial assets. Lower income households have fewer options to invest in physical assets and may choose to hold a relatively larger proportion of their assets in financial forms.

31. There is considerable debate over the influence of interest rates on savings. An increase in interest rates may stimulate savings by making current consumption expensive in terms of future consumption (substitution effect), or may lower savings by reducing the amount of present savings necessary for a given level of future consumption (income effect). The available evidence suggests the substitution effect is more important, but not overwhelmingly so [Lanyi and Saracoglu]. The important issue for financial intermediation in LICs is the relationship between rates of interest paid on deposits and savings in financial forms. Advocates for higher rates argue that peasants are economically rational in their financial affairs, and even poor households need and benefit from attractive deposit and savings services. They feel that countries (such as Taiwan and South Korea) have mobilized surprisingly large amounts of rural savings when deposit rates were changed substantially, while rural savings have been depressed in other countries because real deposit rates have been highly negative due to high inflation rates [Adams (1984c); Benoit; Mittendorf]. Additional evidence on rural deposit potential is found in rehabilitation projects for rural savings institutions that successfully mobilized large amounts of deposits when interest rates were raised and other incentives were given to savers [Gonzalez-Vega (1984c); Poyo; Vogel (1984a)]. Fry (1984) and Gupta

found that financial deposits responded more to real interest rates than did national savings due to the substitution of financial investments for other investments. It appears, therefore, that deposit rates are of more direct importance for financial intermediation than they are for aggregate savings.

32. Transactions costs are important because they influence the net return obtained from any given interest rate. These costs for rural savers include the explicit costs of photographs, passbooks, travel costs, and other cash costs of making deposits. Many institutions also require complicated procedures for the withdrawal of savings. Implicit costs include traveling and waiting time to make deposits and withdrawals. Few empirical studies are available, but it is expected that high transaction costs discourage savers, particularly those with small accounts. Besides explicit regulations on minimum size deposits, it is argued that financial institutions impose high transactions costs to discourage small accounts. Conversely, institutions can easily reduce transactions costs for preferred customers by simplifying or speeding up some procedures or requirements.

33. The proximity of deposit-taking institutions may be the most important factor affecting customer access to and transactions costs for financial services. Strong incentives have been given by some LIC governments to expand bank branches into rural areas [Kwarteng; Meyer and Esguerra]. Progress has been uneven, however, so additional branch expansion is frequently recommended [FAO (1984b, 1981a)]. The incentives for branching have sometimes led to uneconomic operations and uneven distribution with too many branches in some regions and too few in others. Mobile banks and part-time offices have been tried in some countries, but more effort is required to design methods which bring cost-effective financial services closer to rural households. Private voluntary agencies in some countries form groups of poor households to engage in small saving and borrowing activities but more analysis is required to determine if this is a cost-effective alternative for formal financial institutions.

34. Another important factor expected to affect rural deposits is the linkage between savings and lending. Many analysts believe that an important reason for rural households to hold deposits is the possibility of eventually getting a loan. This implies that institutions should link savings mobilization with lending, but in practice many rural financial institutions are single function. Savings mobilization activities were expanded in Africa during the 1970s through the creation of new savings institutions and transformation of post office savings banks into savings and credit banks. Achievements were made in tapping the vast savings potential, but progress has lagged in the development of lending activities [Mauri]. On the other hand, few specialized lending institutions in many LICs mobilize significant amounts of rural deposits. Specialization in only one side of financial intermediation appears

to be inappropriate for two reasons; one is that the motivation for savings is destroyed when the link is broken between savings and loans, and the second is because of operational efficiency, which will be discussed in the next section.

35. Finally, a wide variety of social factors influence deposit mobilization in rural areas. Some countries need to find alternative methods to reward savers because of religious opposition to the concept of interest. Group saving may be an important approach in some areas where rural people are skeptical of formal institutions or are frightened of dealing with bank staff. In many countries it is believed that women control household finances and frequently old, widowed or divorced women hold large amounts of liquid savings. Customs may require that they limit their business dealings to other women so female employees may be required in financial institutions to serve female customers.

V. RURAL SAVINGS AND INSTITUTIONAL VIABILITY

36. Mobilization of rural savings may be an expensive undertaking for formal financial institutions. Encouraging lending institutions to mobilize more rural deposits would seem to exacerbate their already serious financial problems, making them even more unviable. Although mobilizing more rural deposits could increase institutional costs, there are reasons to expect that costs will actually decline. Increased rural deposit mobilization may also contribute to institutional viability by improving loan repayment.

Institutional Costs

37. Growth in deposits relative to other sources of funds would seem to increase an institution's average cost of funds. First, the liabilities of many institutions currently operating in rural areas are mainly composed of subsidized or "cheap" sources of funds. These funds are available through interest-free government deposits, direct capital investments, special rediscount provisions, targeted lines of credit, and obligatory deposits of commercial banks that fail to meet lending quotas. Specialized lending institutions, in particular, rely on these sources of funds [Bourne and Graham]. Second, creating an extensive rural branch network to mobilize deposits appears to be expensive. Even if rural savings are more plentiful than normally assumed, the administrative costs of full-service rural bank branches might be excessive.

38. Recent research suggests that "cheap" funds are more expensive for institutions than they appear, while deposits may not be as expensive as feared for institutions engaging in both deposit mobilization and lending. It is frequently assumed that specialization in economic activities leads to increased efficiency in resource use, but there appear to be important qualifications to this rule for financial institutions. The cost-complementarities that financial intermediaries can attain through the provision of

multiple services suggest that economies of scope may be more important than economies of scale. An empirical test of this proposition was conducted in Honduras by comparing the cost structure of a commercial bank with the Agricultural Development Bank (ADB) [Cuevas]. The results showed that the ADB could most efficiently expand by mobilizing more deposits, while the commercial bank could most efficiently expand by increasing agricultural lending. Lending costs were less than 3 percent for the commercial bank, but more than 8 percent for the ADB. Part of this difference was due to larger average size loans in the commercial bank and part was due to source of funds. The ADB mobilized only about 40 percent of its funds compared to over 90 percent for the commercial bank. The ADB operation was more centralized and expensive because of the reporting requirements for special credit lines and external funds. An analysis of the commercial bank branches showed that even though the size of loans was much higher, lending costs for donor-funded loans were almost 8 percent compared to a range of 1 to 6 percent for loans made with the bank's own funds. Increasing mobilized funds and reducing participation in donor-sponsored programs is very cost-effective in this type of situation [Cuevas and Graham (1984a)].

39. Screening loan applicants is one of the important functions that increases lending costs. The ADB in Honduras spent proportionately more that the commercial bank on loan monitoring and supervision in an attempt to channel loans to targeted purposes [Graham and Cuevas]. Institutions that both mobilize deposits and make loans have important advantages in loan screening because they frequently have additional information about the loan applicant. They may be familiar with the applicant's cash flow, savings habits and wealth, which contributes to better lending decisions. Furthermore, during the life of the loan, changes in a borrower's deposits and savings can serve as an early warning about potential future loan repayment problems.

40. A final factor that can influence costs and returns of financial institutions is their ability to develop local loan programs. When an institution limits its lending to targeted programs, it must follow regulations on authorized sizes and types of loans, amount to lend each borrower, disbursement and repayment schedules, and collateral requirements. For some borrowers, these regulations are too liberal for sound banking procedures. On the other hand, some applicants with good debt repayment capacity and proven repayment records are denied loans because their projects are not included in the targeted programs. When lenders mobilize their own resources, they can develop loan programs that simultaneously conform closer to their lending standards and supply the needs of local farmers and communities.

Loan Recovery

41. For many institutions, loan recovery is the most serious threat to viability. Administrative costs may be reduced through effective management, but an institution will still fail if it loses 20 to 30

percent of its assets each year through loan default. It is impossible to pass losses of this magnitude on to repaying borrowers through higher interest rates. Furthermore, if delinquency and default reach visible enough proportions, the demonstration effect on other borrowers can result in no one repaying on time. This problem is underestimated by analysts who argue that most loans are eventually repaid. Such logic obscures the fact that, first, slow repayment and non-repayment reduce an institution's ability to recycle funds to other worthy borrowers; second, loan collection activities raise administrative costs and the spread required between deposit and lending rates; and, third, high inflation rates found in many countries destroy the real value of postponed loan repayments.

42. Increased rural deposit mobilization can improve loan recovery for two reasons. The first reason is the psychological factor associated with the willingness of borrowers to repay. When funds are provided by donors or the government, they frequently become identified with gifts or grants, and borrowers assume they need not be repaid or that few effective sanctions will be imposed for nonrepayment. If loan funds are drawn from savings made by members of the community, the willingness of borrowers to repay is often dramatically increased. The use of local savings, thus, promotes borrower responsibility [Deguefe].

43. The second reason is that attitudes of lenders towards loan recovery are also likely to change when the source of funds changes. Specialized credit institutions often consider loan recovery of lesser importance than lending. They spend relatively less effort on loan collection because incentives are greater for meeting lending targets [Graham and Cuevas; Nyanin]. Some donor-sponsored programs, for example, impose penalties if lending targets are not met. When lenders assume farmers will not repay, and they take little action to collect, borrowers confirm the assumptions by not repaying. Loan records are so disorganized in some institutions that it is difficult to know exactly who owes how much and when it was due. Yet, a study in Nepal showed that collection efforts were more important in explaining loan repayment than farm income and other variables [Maharjan, Loohawenchit, and Meyer]. Lenders will become more concerned about collections and accountability when a) deposits are an important source of funds lent, b) lending volume depends on recovery of past loans, c) incentives are given for mobilizing deposits, and d) the safety of savers' deposits requires closer scrutiny of lending activities and institutional operations.

44. Political intrusion in lending is hard to avoid because of the benefits that borrowers obtain from additional liquidity. The opportunity for political interference increases in subsidized credit programs because low interest rates cause an excess demand for loans [Gonzalez-Vega (1984a)]. The greater the subsidy, the more valuable the loan is to borrowers, and the greater the temptation to use influence, bribery and other means to obtain a loan. When loans are made from deposits mobilized locally, the potential for political

intrusion declines because lenders can more easily allocate loans solely on the rate-of-return of a project and debt repayment capacity and integrity of the borrower. Bribery and corruption should also decline when lenders become more aggressive in seeking borrowers for the expanded funds available to lend from mobilized resources. Borrowers may feel little need to repay loans "bought" through bribes so as corruption declines, loan recovery should also improve.

VI. INTERSECTORAL FLOW OF FUNDS

45. Increased deposit mobilization will raise the question of what to do with deposited funds. There is great concern in many LICs about the uses of mobilized funds, and rules and regulations are designed to prevent financial institutions from "siphoning off" local funds and channelling them into urban areas or into other rural areas. Several aspects about the role of financial institutions in intersectoral resource transfers need to be clarified. First, financial institutions often just implement the decisions of households and firms to transfer resources, so the reasons for these decisions must be analyzed [Chandavarkar (1981)]. Second, even within the financial system, the direction of net flows is not straightforward. Rural entrepreneurs may hold their deposits in rural branches while borrowing from urban branches. Third, both the supply and demand conditions for rural loans must be evaluated if rural institutions lend less than is socially desirable. Fourth, the existence of a reliable rural lending institution can provide a credit reserve that encourages farmers to commit more of their own resources for investment and use their borrowing capacity to meet emergencies [Baker and Bhargava]. The impact of financial institutions on rural investment may, therefore, be greater than their reported loans. Fifth, a financial institution has the obligation to generate high and safe returns for depositors. If institutions fail to do so, they will lose the confidence of their customers. Quotas, targeted-lending programs and other policies that attempt to hold resources in rural areas may jeopardize depositors by increasing the risks and decreasing the returns to financial institutions.

46. Far too much emphasis has been placed on forcing or enticing institutions to lend, and far too little concern has been given to demand for loans. Expanded rural savings mobilization will not only provide important savings benefits to rural people, but it will also increase the demand for loans for several reasons. The first reason is that loan demand will likely rise because some households will increase savings, believing they will be eligible for a loan at a later date [Causse]. Some of these households will gain the confidence of institutions through saving and will be granted loans. Secondly, rural people will develop confidence in the dependability of an institution that serves their long-term financial needs by providing a secure place for deposits and making loans. Specialized lending institutions in many LICs are very undependable sources of

loans because of the wide swings they suffer in availability of funds [Bourne and Graham]. Third, the potential exists for expanding loan demand by reducing borrowing costs. The structure of administered interest rates must be changed to allow flexibility that will give lenders more scope for reducing borrowing costs. A Honduras study found that interest rates and borrower transaction costs were negatively related, suggesting that lenders absorb more administrative costs and simplify procedures when interest rates are higher [Cuevas and Graham (1984b)]. This result was particularly significant for small loans. When lenders reduce borrowing costs, farmers are encouraged to borrow more from formal sources.

47. Long-term farm profitability is frequently ignored in analyses of the demand for and supply of farm loans. Many LICs have cheap food policies that undervalue agricultural products in order to promote industrialization. Input subsidies, public investments in research, extension and irrigation, and cheap credit are means to offset the adverse effects of such policies. The penalization of agriculture is not fully compensated, however, because the subsidies are usually relatively small and only a few farmers benefit from them [David; Ray]. Cheap credit cannot compensate for price and technology problems that result in low factor productivity [Pollard and Heffernan]. The diversion and substitution of loan funds in targeted programs is likely to be high when sanctioned loan purposes produce low returns compared to other farm and nonfarm activities [Graham and Pollard]. Frequent changes in agricultural pricing and subsidy policies have discouraged farm investments by increasing farmer uncertainty about future profits. Successful rural savings programs have been linked to well-defined agricultural technical packages that use the largest part of the savings [Mittendorf]. Funds are invested in rural areas when investors feel there are good potential investments, but flow out when the returns on investments are higher elsewhere.

48. Policy makers can do several things to ensure that more rural deposits stay in rural areas. They can increase the rate of return for agricultural investments through changes in price policies, agricultural technology and markets. They can introduce stable policies to decrease risks and uncertainties faced by farmers. These changes will have more long-term impact on farmer demand for loans and lender willingness to lend, than further efforts to push the supply of loans. They can also give lenders more flexibility and incentives to make innovations and create loan programs to meet local needs. For example, the distinction between production and consumption loans must be reevaluated [IFAD]. Large farmers are permitted to borrow to cover production costs, including labor payments that are spent by workers for family consumption, but small farmers are not permitted to borrow for their family consumption needs. Nonfarm enterprises and rural nonfarm firms are often denied loans even though they provide much employment and income [Meyer; Kilby, Liedholm and Meyer]. Lenders must be encouraged to make loans based on debt repayment capacity and borrower integrity and move away

from rigid standards for sanctioned production and consumption activities.

VII. PROBLEMS ENCOUNTERED IN IMPLEMENTING FINANCIAL REFORMS

49. Mobilizing more rural savings canl help reduce dependence on foreign assistance and improve performance of RFMs in LICs. Comprehensive changes must be made in rural financial institutions and in government policies and programs, however, if rural deposit mobilization is to be successful. Information now available on recent AID projects to strengthen rural deposit mobilization and broaden financial institutions in Jamaica, Peru, Honduras, the Dominican Republic and Bangladesh suggest the following factors are important for success [Gonzalez-Vega (1984c); Graham and Connally; Poyo; Vogel (1984a)].

Government Policies and Programs

50. The first step in financial reform is the requirement that governments must shift priorities from pushing cheap credit for farmers to building viable financial systems. They can then begin to design ways to improve deposit mobilization. A revision in rural deposit interest rates will be a necessary step in many LICs because interest rates for deposits frequently must be increased to mobilize more savings. Interest rates on farm loans will also have to be raised to permit an increase in interest spreads so institutions can cover costs. Flexibility in interest rates is required to adjust for variability in inflation. The rate structure and the extent to which markets are permitted to determine rates will vary from country to country. "Optimum" rates are difficult to determine, but policymakers should evaluate the structure of nominal interest rates compared to real interest rates, world interest rates, rates of return on investments, the spread between savings and lending rates, and interest rates in informal credit markets (Pereira Leite). Maintaining rates that are normally positive in real terms will be a minimum standard for most LICs. Alternatives to interest rates must be provided in countries where religious beliefs discourage explicit payment of interest.

51. Governments need a strong institutional framework for stimulating and monitoring the financial sector. This responsibility often must fall on the central bank. Some LICs need to create a central monetary authority, while others should strengthen their existing central bank. Instead of emphasizing rural credit supplies, the primary role of the central bank should be to oversee the development of viable rural financial institutions. Several technical issues must be resolved, and the central bank is the logical government agency to provide leadership for the following tasks.

A. Develop an appropriate mix of rural financial institutions. It is unlikely that a single type of rural financial institution will be optimal for all LICs. Each country must develop a mix of institutions consistent with its particular needs with emphasis on two criteria for institutional development. First, multifunctional institutions that link savings and credit activities should be expanded. This involves strengthening the lending activities of specialized savings institutions and the savings mobilization activities of specialized lenders. Second, a range of institutional forms must be provided to meet the needs of specific rural markets. A network of full-service bank branches may be appropriate for semi-urban areas, while simpler institutions may be sufficient for smaller isolated areas. Some institutions may be encouraged to retail financial services in unbanked areas but offer only wholesale services where other local retailers are operating efficiently. Incentives should be given to institutions for testing the efficiency of alternative forms of financial services in rural areas. Links between formal and informal institutions should be explored.

B. Foster and regulate competition. Expanding multifunctional rural financial institutions opens up possibilities for increased competition and efficiency in the provision of financial services. A trade-off exists between competition and economies of scale [Khatkhate and Riechel]. Restricting competition may permit a few institutions to achieve economies of scale, but may also encourage monopoly powers that prevent desired reductions in prices of financial services. Competition may be encouraged at the national level, but restrained in specific rural areas due to small market size. Central bank rules that authorize the creation of new financial institutions, sanction specific services, and regulate branching must be applied with caution because of their impact on competition and economies of scale and scope.

C. Assist with liquidity and risk management. Operating risks for institutions may decline when they increase their scope of financial services, but there are also ways in which liquidity and risk management problems will increase. Specialized lending institutions, dependent upon reliable government or donor funds, may find that deposits are more volatile and difficult to manage as a substitute source of funds. Specialized savings institutions may find that the risk of their asset portfolios increases with agricultural lending. Even though lenders broaden the range of activities funded in rural areas, loan portfolios composed only of loans for farm related enterprises may represent more risk than those diversified across several economic sectors. The central bank must explore methods that help institutions manage risk and liquidity problems such as interbank lending agreements, occasional rediscounting facilities, and loan guarantee and insurance programs. Reserve requirements must be flexible and adjusted in response to changes in liquidity positions. Rules on debt to equity requirements for rural institutions must be stringent enough to encourage capitalization for possible loan losses, yet liberal enough so institutions can increase income through greater leverage.

D. Create and supervise management information systems. Many institutions have record-keeping systems that primarily produce reports required for government agencies or donors such as loan disbursements by type, size, enterprise funded and size and type of borrower. This information clogs information channels and provides little useful data for managers on income, expenses, cost of funds and quality of loan portfolio. Likewise, central banks emphasize global measures such as deposits mobilized and loans made, but many do not collect and analyze income and expense data to evaluate institutional viability. Management information systems must be restructured by stripping away nonessential information on loan targeting and concentrating instead on data collection to monitor the financial health of institutions [Graham and Firestine]. The introduction of micro-computer hardware and software systems could greatly facilitate data management and analysis within the central bank and individual institutions. Careful audit and inspection functions must be performed by the central bank to maintain customer confidence in financial institutions.

E. Create a research and analytical capability. Development of viable RFMs requires research and analysis at three levels: a) rural households and firms, b) financial institutions and c) national monetary and credit issues. Institutions must be developed and strengthened to undertake this work. Research will be needed in many LICs on topics such as: inflation projections for interest rate analysis, market studies to identify consumer preferences regarding financial instruments, design and evaluation of savings campaigns, scope and magnitude of potential financial services for specific rural market areas, incentives for improved institutional efficiency and demand factors that influence the allocation of credit. This broad range of issues requires researchers within the central bank and financial institutions, and private and public research institutions. The central bank must develop capacity to conduct research on issues for which it is best qualified, suggest where and how research on other related issues is institutionalized and identify key topics for study as the financial sector undergoes change and growth.

F. Design and conduct training and technical assistance programs. Personnel problems of financial institutions have led to research on training requirements and the content of training courses [Roberts]. Manpower constraints will become even more serious when single function institutions broaden their scope of financial services. New skills will be necessary when savings institutions require expertise for lending activities, and lending institutions need personnel trained in deposit procedures. Loan officers must learn to evaluate loan applications based on creditworthiness rather than merely following regulations for targeting enterprises. Demands on managers will increase when financial viability becomes an important evaluation criterion. Managers will need to design loan programs and develop criteria for creditworthiness instead of simply following instructions issued for lending programs. Productivity measures will be needed to quantify costs of operations, profits or surplus per unit/branch, transactions costs and margins required to cover costs. Decisions will be required on which branches to expand, the rate to expand new services, the minimum size of market area for opening a new unit/branch and new innovations for lending and deposit mobilization. The central bank can design some of these concepts, suggest standards, develop courses and materials for staff training and arrange technical assistance to transfer ideas used successfully elsewhere.

52. Governments undertaking financial reforms will find that at least two issues in addition to bank operations will affect success. The first concerns policies and programs that affect the magnitude and variability of farm profits and farmers' debt repayment capacity [Von Pischke (1984)]. Demand for loans, loan recovery and the financial strength of rural financial institutions are directly related to incomes of farm households. Steps have been taken in some LICs to change policies that undervalue agricultural products, but more are required. Additional long-term investments must be made in research and extension to improve agricultural technology. Irrigation, price and marketing policies, crop guarantee and insurance programs and other measures are needed to combat production and income variability. The second issue concerns use of mobilized funds. The expanded pool of rural deposits will provide greater opportunities for rural and urban investors to successfully compete for loans. Private investors will be crowded out of the financial markets, however, if governments choose to appropriate these deposits by raising mandatory reserve requirements, by increasing targets for nonagricultural loans, or by setting high interest rates for government securities. If this happens, the positive impact of deposit mobilization will be limited to improved income for rural savers, but with little improvement in the magnitude of private investment.

A Different Role for International Agencies

53. International agencies can play an important supportive role in rural financial reforms by limiting their support to governments trying seriously to create viable rural financial institutions. There will be limited scope and funds for traditional large scale transfers of funds for on-lending through RFM and other projects. Such transfers, in fact, diminish or destroy the incentives needed for reform. If a transfer of funds to agriculture is desirable for foreign exchange purposes, the funds should be directed towards easing adjustment problems in countries undertaking financial reforms, towards investments in agricultural research, extension, education, markets, or other infrastructure which increase the demand for loans. Important projects of small to medium scale can be developed to strengthen central banks and other financial institutions, to subsidize start-up costs for institutions broadening their financial services, to develop research capacity, and to fund experiments to test financial innovations. Foreign exchange may be useful for technical assistance to transfer technology and procedures

from successful institutions in other countries, and for programs to develop and operate regional training and research centers. Selected expenditures for foreign manufactured equipment and supplies may be important for new information systems. An active program is needed to facilitate the international exchange of ideas and lessons learned from financial reform programs.

Monitoring Performance

54. Programs to reform and broaden RFMs require monitoring to determine the rate of progress, the bottlenecks or constraints on implementation, and policy changes that are needed. Monitoring requires a) the selection of a set of monitoring criteria, and b) the collection and analysis of appropriate data. The primary criterion for evaluation of many RFM projects in their early stages of implementation is the amount of funds lent. Later, when loan collection problems begin to develop, the criterion of loan recovery is added. After a project is completed, ex post evaluations frequently try to measure loan impact on borrowers. The emphasis is largely on the borrower at all three stages, rather than on the financial health of the institution. Five criteria are proposed here for use in monitoring performance.[3]

A. Access. Financial institutions provide services to customers, so a logical evaluation criterion is the number of people with regular access to these services. In rural areas, this criterion implies monitoring the number of persons who regularly use deposit accounts and receive loans. The geographic spread of persons with access to financial institutions and their income and wealth characteristics will be important to measure. An approximation of trends in access can be obtained by periodically constructing a profile of users drawn from a sample of rural savings and loan accounts. When financial services become more complex and rural households use more than one institution, an occasional field survey of households may be needed to determine the number and characteristics of people who do not use any financial institutions.

B. Savings mobilization. The second performance criteria is savings mobilization, and it should be considered in several dimensions. The aggregate amount of deposit and savings accounts in rural areas is important because it influences the supply of funds available for lending. Trends in deposits of individual institutions may reflect success in employing different methods in savings mobilization. Measuring trends in total deposits in a given market will show the extent to which competition for savings results in disintermediation among institutions rather than a net increase in aggregate deposits.

C. Loan recovery. Loan repayment is indicative of the value borrowers place on maintaining long-term relationships with an institution. Borrowers who value the relationship and desire future loans will make every effort to keep existing loans current and will work closely with lenders to resolve delinquencies. High arrears rates may reflect unusual production and marketing problems, but may also reflect poor quality of loan services and high borrower transactions costs for new loans. Therefore, monitoring loan recovery and the age-wise structure of delinquencies is a useful proxy for quality of service. Loan recovery data also are important because of the impact of delinquency and default on institutional viability.

D. Efficiency. The fourth criteria is efficiency because the human and physical resources used in financial intermediation have alternative economic uses. For management decisions, efficiency measures are needed within an institution, such as number of deposit or loan accounts per bank officer and profits or surplus per unit of savings mobilized or loans made. The long-term objective of financial intermediation is to increase the real rate of interest paid on deposits and decrease the real cost of loans. Transactions costs influence the net return received by savers and the total cost of borrowing, so they are important efficiency measures to monitor. Transactions costs borne by the institution determine the minimum spread required to cover its costs. It is useful to monitor transactions costs of both institutions and their customers because a decrease in one may be offset by an increase in the other. Differences in transactions costs among institutions may suggest ways for high cost institutions to reduce costs.

E. Institutional viability. The final criterion refers to an institution's ability to maintain self-sustaining growth. This measure is affected by performance in the other four criteria. An institution that provides access to a large number of users, mobilizes a large share of the resources it lends, has a high recovery rate on loans, and is efficient will likely achieve long-term growth and stability. Profits or surplus are traditional measures of viability, but other indices are the amount of government subsidies received and the minimum spread between cost of funds and loan rates required to cover costs and lending risks. Measures of an institution's ability to withstand adversity are also useful to monitor such as debt to equity ratio and reserve for bad debts.

VIII. CONCLUDING COMMENTS.

55. Many LICs face two important interrelated challenges involving rural finance. One challenge is to increase the national savings rate and reduce dependence on external savings. The second is to improve the performance of their RFMs. The central argument of this paper is that greater deposit mobilization, especially in rural areas, can contribute to meeting both challenges.

56. Major efforts have been made in the past two decades to strengthen rural finance. Unfortunately, the emphasis has been limited largely to channelling cheap credit to farmers. Although the objectives are commendable - increase farm income, accelerate

technological change, expand exports - the results have been modest compared to expectations. More seriously, the approach actually undermines mobilization of domestic resources and destroys the viability of financial institutions. Any benefits received by target groups and beneficiaries from loans come at a high cost to the sustained development of rural financial institutions. Typically the initial experimental projects never expand beyond benefitting a fairly small group of farmers compared to the large rural population that would benefit from reliable financial services.

57. Awareness is growing that the traditional agricultural credit approach has serious shortcomings, but the nature of the reforms to be made are not yet clearly understood. This paper argues that deposit mobilization provides the cornerstone for reform. Increased attention to deposit mobilization will force institutions to provide more attractive savings alternatives for rural households, will place high quality customer services as a high priority, will require institutions to more carefully allocate loans on the basis of debt repayment capacity, and will stress loan recovery in order to protect customer deposits. A stronger deposit base will free institutions from some of the current political influence in lending and loan recovery decisions, and will make them more independent of the vagaries of government and donor support.

58. Financial reform will be difficult, complex and long term. Many important technical issues must be resolved and significant changes will be required in the operations of lending institutions. The central bank must assume a key role in setting policies, providing guidance and conducting research on constraints and problems of rural financial institutions. Political issues will also be important. Strong vested interests have developed to preserve the status quo: the select few farmers who receive the subsidized loans, the politicians who gain favor by granting loans and ignoring repayment, the bank officials who receive promotions through meeting lending quotas, and the donor agency staff who are rewarded for the efficiency with which they transfer large amounts of assistance funds to recipient countries. These interests provide plenty of reasons for pessimism about the prospects for reform.

59. There are, however, encouraging signs that are supportive of a fundamental reorientation in approach to rural finance. One is the large volume of research available from several sources which documents the shortcomings of the cheap credit approach. The second is that the donors no longer have a large amount of funds available for such projects. Third, financial problems are receiving great attention at the policy level because of LIC indebtedness and a few highly publicized failures of banking institutions in several countries. Fourth, there is a groundswell of support in many LICs for policy reforms which give market forces greater scope in resource allocation, which reduce the role of government in setting prices, and which place greater reliance on private rather than public sector institutions.

60. The challenge for donors is to find ways to meet their legitimate concerns for equity within this changing economic and political environment. They have an excellent opportunity to influence the outcome of financial reform, and they should concentrate their efforts in three areas. First, they should focus financial sector support on those countries that are seriously undertaking reform rather than scatter resources on loan programs in countries where conditions prevent self-sustained expansion of pilot efforts. Second, donors should channel scarce technical and financial resources into easing the adjustment problems that countries and institutions confront when conducting reforms. Third, they should encourage and help evaluate innovations that will lead to self-sustained development of financial services in rural areas recognizing that secure deposit services are as important for some rural households as loans are for others.

FOOTNOTES

1. This paper draws heavily from a draft paper recently prepared by the author for FAO entitled "Deposit Mobilization for Rural Lending". I would like to acknowledge with appreciation those friends and colleagues who have influenced my thinking most about rural finance: Dale W Adams, Paulo F. C. de Araujo, Carlos E. Cuevas, Cristina C. David, Claudio Gonzalez-Vega, Douglas H. Graham, Jerry R. Ladman, Donald W. Larson, Robert C. Vogel and J. D. Von Pischke. I also want to recognize the important support provided to OSU over the years by the Agency for International Development and project officers, Cliff Barton, Robert E. Firestine and Sandra Frydman Henderson. The views expressed in this paper are my own and may not necessarily be shared by AID nor by the persons identified above.

2. Nominal interest rates (i) refer to those set in loan and deposit contracts. Real interest rates (r) refer to the difference between nominal interest rates and the rate of inflation (p), frequently calculated as simply i-p. When price changes are greater than nominal interest rates, the return on deposits or cost of loans can be negative in real terms.

3. This section draws on a recent paper by Adams (1985) in which four variables are proposed for use in monitoring programs with an emphasis on lender viability: a) number of people with regular access to financial services, b) transactions costs, c) quality of services provided and d) savings mobilization.

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